

MR. BEACH: Mr. Chairman, members of the Commission, thank you very much for inviting my testimony this morning.

The role that I anticipate playing on this panel is that of someone who is working with structural models of both the U.S. economy and of international trade, and so I'm going to make a few comments about the strengths and limitations of those models. They are tools for this Commission to use in understanding the effects of net exports or trade deficits or changes in the current account balance, and perhaps I can add some light to that, and also to briefly describe two scenarios that we ran for this Commission, both of which depend heavily on the performance of foreign economies and not necessarily on our own policy outcomes and the debates we're having on taxes and other things of that nature.

Mr. Chairman, I'm going to read just a fragment of my remarks and then conclude.

At the risk of trenching heavily on the Commission's patience, let me state the obvious. This country's current account balance can be affected in far more ways than could ever be captured in an economic or econometric model. The millions of daily decisions that

buyers and sellers make influence relative prices across international boundaries, alter the direction of capital flows, and shape the interplay of currency exchange rate.

The continuousness of these enormous changes and the unimaginable complexity of the information signaling system upon which the structure of international trade depends make utterly impossible any attempt to fully model international trade. All modelers know this constraint on their work; therefore, they approach with significant humility the type of analytical challenge you've laid before us today: What are the impacts of the trade deficit on the U.S. economy?

Besides calling it a mission impossible, I am sorely tempted to say that the question contains far more interesting political than economic content. For instance, if increasing foreign ownership of U.S.-based assets is one effect or outcome of running relatively large current account deficits, a somewhat intriguing economic issue arises about how much better a non-U.S. owner will be in managing the asset's economic value.

However, who owns the asset is hardly relevant when you have completely open economies.

On the other hand, nationality does matter

a great deal, if negative current account balances are approached politically, which is the same thing as saying that the trading world is not composed entirely of open economies. All politics is local or with respect to international trade, national. Politicians will have their say and rightly so.

Can economists say more or econometricians, people working with models, say more on trade deficits other than, "Don't worry. It all somehow works out?"

I think so. I believe important insights can be obtained from those models of the U.S. that attempt to capture the country's basic economic structure and how it responds to policy changes over time. Heritage's model belongs to this variety of forecasting tools and can be employed to show some otherwise unexpected effects from changes in trade flows.

The U.S. macroeconomic model is best suited to evaluating the economic effects of subtle changes in policy or the performance of the U.S. economy relative to its major trading partners. We learned in the course of preparing this testimony that counterfactuals do not do well in structural models, and we use several models to ascertain whether this is true.

For example, you can't ask a structural model, what would the U.S. economy look like if the

software industry had developed in France rather than the United States? Or how much different would the U.S. trade deficit be had there been no Asian financial crisis?

One can ask, however, how changes in the exchange rate or the growth rates of major economic partners might affect U.S. economic performance, and it is just that ambitious variety of questions that we explored for this hearing -- how do basic economic indicators change when the dollar weakens or when it strengthens against the currencies of our major trading partners?

I have attached to my testimony, which is in the hands of all the commissioners, two scenarios -- one that I call foreign weakening and one which I call foreign strengthening. Both depend upon changing the assumptions about how prices in the 18 to 22 major trading partners are changing relative to U.S. prices at the producer price level and how the economies of the trading partners are changing relative to the growth rates of the U.S. economy. And I'd be happy to discuss that.

I raise this -- I bring this to the table because I do believe if you make reasonable assumptions, Mr. Chairman and members of the Commission, you supply

these models with some reasonable instructions about how to simulate changes in the trading regime, that they have significant information to yield. The world is far too complicated to keep everything in mind, and these models do a very nice job of doing that for us.

Thank you very much.

CHAIRMAN WEIDENBAUM: Thank you, Mr. Beach.

Our fourth briefer is Professor Gesa Feketekuty of the Monterey Institute of International Studies and previously assistant special trade representative.

Mr. Feketekuty.